

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:RFP:MIA:TL-N-1237-01

JPDawson

date: APR 10 2001

to: Ivan Ceballos, LMSB Group 1717  
Attn: R/A Osvaldo Crespo

from: Area Counsel  
(Retailers, Food and Pharmaceuticals)

---

subject: [REDACTED]  
**Accumulated Earnings Tax**

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the I.R.S. recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to I.R.S. personnel or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on the I.R.S. and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

**ISSUE**

Whether for taxable years ending [REDACTED] and [REDACTED], [REDACTED] (hereinafter referred to as taxable years [REDACTED] and [REDACTED], the accumulated earnings tax should be imposed on [REDACTED].



During taxable years [REDACTED] and [REDACTED] taxpayer's financial statements reflected the following acquisitions/expenses:

	[REDACTED]	[REDACTED]
Building Improvement	\$ [REDACTED]	\$ [REDACTED]
Machinery and Equipment	[REDACTED]	[REDACTED]
Transportation Equipment	[REDACTED]	[REDACTED]
Project in Progress	[REDACTED]	[REDACTED]
Repairs	[REDACTED]	[REDACTED]

#### Dividend History

The only dividend, declared and not paid, was on the preferred stock. Taxpayer issued [REDACTED] shares of [REDACTED] cumulative preferred stock. For each of the years ended [REDACTED] and [REDACTED] \$[REDACTED] of dividends have been declared to the holders of the Company's [REDACTED] cumulative preferred stock. The total amount of dividends declared and not paid accumulated as of fiscal year ending [REDACTED] was \$[REDACTED]. Taxpayer explained that its failure to pay the declared dividends was a result of the terms of the Revolving Credit and Loan Facility. Per this agreement, taxpayer could not pay the dividends without written permission from the Bank. Taxpayer never asked for a waiver of the restriction.

#### **ANALYSIS**

The accumulated earnings tax is imposed on the accumulated taxable income of every corporation formed or availed of for the purpose of avoiding the income tax with respect to its shareholders, by permitting earnings and profits to accumulate instead of being divided or distributed. See I.R.C. §§ 531 and 532. The purpose of the accumulated earnings tax is to compel the company to distribute any profits not needed for the conduct of its business so that individual stockholders will become liable for taxes on the dividends received. See Ivan Allen Co. v. United States, 422 U.S. 617, 626 (1975); United States v. Donruss Co., 393 U.S. 297, 303 (1969); Helvering v. Chicago Stock Yards Co., 318 U.S. 693, 699 (1943). The tax is considered to be a penalty and, therefore, has been strictly construed.

Earnings and profits of a corporation permitted to accumulate beyond the reasonable needs of the business are

determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation proves otherwise by a preponderance of the evidence (to the contrary). See I.R.C. § 533(a); Technalysis Corp. v. Commissioner, 101 T.C. 397, 403 (1993); Hughes, Inc. v. Commissioner, 90 T.C. 1, 16 (1988); Snow Manufacturing Co. v. Commissioner, 86 T.C. 260, 269 (1986).

#### Net Liquid Assets

The accumulated earnings and profits of prior years are taken into consideration in determining whether any amount of the earnings and profits of the taxable year has been retained for the reasonable needs of the business. See Treas. Reg. § 1.535-3(b)(1)(ii). The critical factor is not the monetary size of the accumulated earnings and profits, but the corporation's liquid position and the relation of that position to the corporation's current and anticipated needs. See Ivan Allen Co. v. United States, *supra* at 628; Faber Cement Block Co. v. Commissioner, 50 T.C. 317, 329 (1968). Investments in properties or securities that are unrelated to the activities of the business of the taxpayer corporation may also indicate that earnings and profits of a corporation are being accumulated beyond the reasonable needs of the business. See Treas. Reg. § sec. 1.537-2(c). Thus, the first step is to determine petitioner's net liquid assets for the purpose of determining the funds available to petitioner to meet its business needs. See Wilcox Manufacturing Co. v. Commissioner, T.C. Memo. 1979-92.

Petitioner's liquid assets available are calculated as current assets less current liabilities for each tax year in issue. During taxable year [REDACTED] the financial statements and the corporate minutes reflect a \$ [REDACTED] investment in marketable securities.

The taxpayer's current net liquid assets for taxable year [REDACTED] are calculated as follows:

Current assets	\$ [REDACTED]
Less: Current liabilities	[REDACTED]
Current net liquid assets	\$ [REDACTED]

#### Reasonable Needs of the Business

The second step is to decide whether the grounds asserted by petitioner justify the accumulation of earnings and profits for its reasonable business needs. The term "reasonable needs of the business" includes "the reasonably anticipated needs of the business." See I.R.C. § 537(a).

The need to retain earnings and profits must be directly connected with the needs of the corporation, itself, and must be for bona fide business purposes. See Treas. Reg. § 1.537-1. The regulations adopt a "prudent businessman" standard for determining whether earnings have been accumulated beyond the present and reasonably anticipated future needs of the business. Treas. Reg. § 1.537-1, states, in part:

An accumulation of the earnings and profits \* \* \* is in excess of the reasonable needs of the business if it exceeds the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business.

Thus, determining the reasonable needs of a business is, in first instance, a question for the officers and directors of the corporation. See Snow Manufacturing Co. v. Commissioner, 86 T.C. 260, 269 (1986); John P. Scripps Newspapers v. Commissioner, 44 T.C. 453, 468 (1965); Crawford County Printing & Publishing Co., 17 T.C. 1404, 1414 (1952). The courts have been hesitant to substitute their judgment and attribute a tax-avoidance motive unless the facts and circumstances clearly warrant the conclusion that the accumulation of earnings and profits was unreasonable and for the proscribed purpose. See Snow Manufacturing Co. v. Commissioner, supra at 269; Atlantic Properties, Inc. v. Commissioner, 62 T.C. 644, 656 (1974).

Whether a particular ground or grounds for the accumulation of earnings and profits indicate that the earnings and profits have been accumulated for the reasonable needs of the business or beyond such needs is dependent upon the particular circumstances of the case. Treas. § 1.537-2(a), Income Tax Regs.

#### Working Capital Needs for Operating Cycle

Earnings retained to provide for working capital requirements are accumulated for the reasonable needs of the business. See Treas. Reg. § 1.537-2(b)(4). The working capital needs of a business are commonly evaluated by means of the "Bardahl formula". See Technalysis Corp. v. Commissioner, 101 T.C. 397, 407 (1993); Bardahl Manufacturing Corp. v. Commissioner, T.C. Memo. 1965-200.

Internal Revenue Manual (IRM) § 4233 directs that the initial determination of whether to propose the excess accumulations tax should be based on a Bardahl-type analysis. The Bardahl formula sets out a mechanical working capital needs analysis to aid in determining the taxpayer's reasonable needs

The need to retain earnings and profits must be directly connected with the needs of the corporation, itself, and must be for bona fide business purposes. See Treas. Reg. § 1.537-1. The regulations adopt a "prudent businessman" standard for determining whether earnings have been accumulated beyond the present and reasonably anticipated future needs of the business. Treas. Reg. § 1.537-1, states, in part:

An accumulation of the earnings and profits \* \* \* is in excess of the reasonable needs of the business if it exceeds the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business.

Thus, determining the reasonable needs of a business is, in first instance, a question for the officers and directors of the corporation. See Snow Manufacturing Co. v. Commissioner, 86 T.C. 260, 269 (1986); John P. Scripps Newspapers v. Commissioner, 44 T.C. 453, 468 (1965); Crawford County Printing & Publishing Co., 17 T.C. 1404, 1414 (1952). The courts have been hesitant to substitute their judgment and attribute a tax-avoidance motive unless the facts and circumstances clearly warrant the conclusion that the accumulation of earnings and profits was unreasonable and for the proscribed purpose. See Snow Manufacturing Co. v. Commissioner, supra at 269; Atlantic Properties, Inc. v. Commissioner, 62 T.C. 644, 656 (1974).

Whether a particular ground or grounds for the accumulation of earnings and profits indicate that the earnings and profits have been accumulated for the reasonable needs of the business or beyond such needs is dependent upon the particular circumstances of the case. Treas. § 1.537-2(a), Income Tax Regs.

#### Working Capital Needs for Operating Cycle

Earnings retained to provide for working capital requirements are accumulated for the reasonable needs of the business. See Treas. Reg. § 1.537-2(b)(4). The working capital needs of a business are commonly evaluated by means of the "Bardahl formula". See Technalysis Corp. v. Commissioner, 101 T.C. 397, 407 (1993); Bardahl Manufacturing Corp. v. Commissioner, T.C. Memo. 1965-200.

Internal Revenue Manual (IRM) § 4233 directs that the initial determination of whether to propose the excess accumulations tax should be based on a Bardahl-type analysis. The Bardahl formula sets out a mechanical working capital needs analysis to aid in determining the taxpayer's reasonable needs

for accumulated earnings. The Bardahl formula uses the following three turnover ratios:

- (1) Inventory turnover.
- (2) Accounts receivable turnover.
- (3) Accounts payable turnover.

Applying these ratios, the taxpayer's current operating needs for [REDACTED] are:<sup>1</sup>

- (1) Inventory turnover:

$$[(\text{Beg. Inv.} + \text{End. Inv.})/2] / \text{cost of goods sold} \\ [(\text{[REDACTED]} + \text{[REDACTED]})/2] / \text{[REDACTED]} = \text{[REDACTED]}$$

- (2) Accounts Receivable turnover:

$$[(\text{Beg. Acc. Rec.} + \text{End. Acc. Rec.})/2] / \text{Sales} \\ [(\text{[REDACTED]} + \text{[REDACTED]})/2] / \text{[REDACTED]} = \text{[REDACTED]}$$

- (3) Accounts Payable turnover:

$$[(\text{Beg. Acc. Pay.} + \text{End. Acc. Pay.})/2] / \text{Purchases} \\ [(\text{[REDACTED]} + \text{[REDACTED]})/2] / \text{[REDACTED]} = \text{[REDACTED]}$$

Net operating cycle ratio [REDACTED]

Annual operating expenses:

Cost of goods sold \$ [REDACTED]

Other Deductions:

\$ [REDACTED]

Total other deductions \$ [REDACTED]

Less: Depreciation [REDACTED]

"Cash" operating expenses \$ [REDACTED]

Times: Net operating cycle ratio  $\times$  [REDACTED]

Current operating needs \$ [REDACTED]

The current working capital needs are then compared to the company's current net liquid assets. The taxpayer's current net liquid assets less the calculated working capital needs yields a current excess working capital of \$ [REDACTED] calculated as follows:

---

<sup>1</sup> Taxpayer's financial information was not provided for taxable year [REDACTED]. Therefore a similar analysis must be made for taxable year [REDACTED].

Current assets	\$ [REDACTED]
Less: Current liabilities	[REDACTED]
Current working capital	\$ [REDACTED]
Less: Calculated working capital needs	[REDACTED]
Excess working capital	\$ [REDACTED]

In the article entitled *Audit Strategies for Defending Against the Accumulated Earnings Tax*, copy previously provided to the Service, various adjustments to the Bardahl computations are discussed that the private sector has successfully utilized challenging the Service's adjustments.<sup>2</sup> These adjustments are the following:

- IRM 4233 specifies that the "trade accounts payable" figure used as the numerator in the calculation should include only those payables relating to inventory purchases. Most smaller companies, however, do not separate inventory-related and non-inventory related payables on their balance sheet. Instead, the taxpayer simply lumps all payables together, and the Service fails to separate out non-inventory payables prior to running the Bardahl calculation.

Because even a small reduction in average accounts payable will generate greater working capital needs under the Bardahl calculation, we recommend that the Service segregate the inventory and non-inventory payables. The Service will have to develop such information from the taxpayer's underlying records.

- Since the whole point of the Bardahl formula is to determine the liquid assets needed to fund the company's normal operating cycle, we recommend that the taxpayer's vendor invoices and canceled checks be inspected to determine the period of time as to when the bills are actually paid. If the Bardahl formula is generating a greater time lag for payment than that which actually occurred then the Bardahl formula will have to be adjusted to reflect the actual payment cycle.
- The Bardahl formula is based on the taxpayer's current assets, current liabilities, payables, inventory, and other items all taken from the company's financial statements. However if one or more of these items have been misclassified, then the formula may be incorrect.

---

<sup>2</sup> See Bruce McClain and Thomas Lechner, *Audit Strategies for Defending Against the Accumulated Earnings Tax*, 64 Prac. Tax Strat. 132 (2000).



Therefore, the Service should inquire of the taxpayer as to whether there any misclassifications on its financial statements.

- To determine taxpayer's liquidity, we recommend that taxpayer's monthly bank statements be reviewed and that the taxpayer's average cash balance be compared with its average cash disbursements. These figures will reveal taxpayer's liquidity which in turn can be compared with its industry standards.

#### Reasonable Needs

From the excess working capital, the Service must also consider the taxpayer's other reasonable needs. Other "reasonable needs of the business" include the following:

- (a) Bona fide expansion of business or replacement or plant. The financial statements and the corporate minutes are silent as to this point.
- (b) Acquisition of a business enterprise through purchasing stock or assets. The financial statements and the corporate minutes are silent as to this point.
- (c) Retirement of bona fide indebtedness created in connection with the trade or business. The financial statements and the corporate minutes provide that taxpayer maintained a \$[REDACTED] line of credit with its bank. However, the balance during [REDACTED] and [REDACTED] on this line of credit was \$[REDACTED]. The only other loans were a \$[REDACTED] [REDACTED] County Industrial Development Authority Tax Free (series A) and \$[REDACTED] (Series B) which were obtained in [REDACTED]. At the end of [REDACTED], the bonds carried rates of [REDACTED] for the Series A and [REDACTED] for the Series B.<sup>3</sup>
- (d) Investments or loans to suppliers or customers. The financial statements and the corporate minutes are silent as to this point.

---

<sup>3</sup> The Balance Sheets reflect, as Long Term Assets, the unused proceeds from the Bonds. The unused proceeds were invested in money market funds according to the financial statements. During [REDACTED] and [REDACTED], the balance on these long term assets were \$[REDACTED] and \$[REDACTED], respectively.

(e) Redemption of stock held by minority stockholders. The financial statements and the corporate minutes are silent as to this point.

(f) Need to meet competition. The financial statements and the corporate minutes are silent as to this point. Conversations with the taxpayer indicated that there was [REDACTED] competitor in Florida, and [REDACTED] or [REDACTED] in the [REDACTED] country.

(g) Reserves for various business risks and contingencies such as self-insurance against casualties, potential liability from litigation, and unsettled business conditions. The financial statements and the corporate minutes provide that the taxpayer was "covered by insurance and will have no material adverse effect upon the Financial Statements of the Company." Taxpayer was self insured for Workers compensation in the amount of \$[REDACTED].

(h) Need to finance pension or profit plans for the employer. The financial statements and the corporate minutes are silent as to this point.

(i) Possible loss of principal customer. The financial statements and the corporate minutes are silent as to this point.

(j) The excess business holdings redemption needs of the business. The financial statements and the corporate minutes are silent as to this point.

(k) An actual or potential lawsuit. The financial statements and the corporate minutes are silent as to this point.

(l) A possible liability arising out of some contractual obligation. The financial statements and the corporate minutes are silent as to this point.

However, the Tax Court has held that plans need not be set forth in minutes of the corporation or otherwise in written form or in a reserve on the balance sheet. Rather, the taxpayer's contemporaneous course of action can be used to determine the existence of the taxpayer's reasonable needs.

Accordingly as to factors (a) through (l), we recommend that the Service inquire from the taxpayer: (1) whether such reasonable need existed, (2) the documents that demonstrate such

reasonable need, and (3) the taxpayer's contemporaneous course of action towards achieving that end. See Eyefull, Inc. v. Commissioner, T.C. Memo 1996-238; Peterson Bros. Steel Erection Co. v. Commissioner, T.C. Memo. 1988-381.

After the Service has received the taxpayer's responses, the Service will then determine whether the taxpayer has accumulated earnings and profits beyond the reasonable needs of its business. If the accumulated earnings and profits are determined to be beyond the reasonable needs of taxpayer's business, the Service is to send by certified or registered mail a notice informing the taxpayer that the proposed notice of deficiency will include an accumulated earnings tax. See I.R.C. § 534(a).

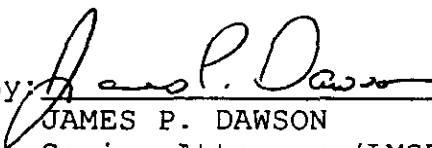
#### CONCLUSION

The Bradahl formula reflects that the taxpayer has excessively accumulated earnings and profits. However we recommend that additional facts be obtained in order to determine whether the taxpayer has accumulated earnings and profits beyond the reasonable needs of its business. Once these additional facts are obtained, the Service can ascertain whether the accumulated earnings tax is to be imposed. If the accumulated earnings tax is to be imposed the taxpayer will be notified by certified or registered mail.

Please be advised that, since this memorandum constitutes nondocketed significant legal advice, it is subject to a 15-day post review in the Office of Chief Counsel. Therefore, no action should be taken to implement the advice contained in this memorandum until at least the expiration of the 15-day period.

The issue was not coordinated with industry counsel because the issue does not appear to be within the scope of the responsibility of any industry counsel. If you have any questions, please call James Dawson at (305) 982-5316.

DAVID R. SMITH  
Associate Area Counsel  
(Large and Mid-Size Business)

By:   
JAMES P. DAWSON  
Senior Attorney (LMSB)

CC: TSS 4510  
Attn: Associate Chief Counsel  
CC: Division Counsel  
CC: Area Counsel